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CAPITAL GAINS AND LOSSES

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INTRODUCTION

This pamphlet presents background information on a number of proposals related to several aspects of capital gains taxation. The subjects included here are the minimum holding period to qualify for long-term capital gains, proposals for a sliding scale to be used in the taxation of long-term capital gains that would reduce the amount of gain included in taxable income for properties held a long time, possible modifications in the alternative tax which limits the rate on the first \$50,000 of capital gains to 25 percent, possible modifications in the tax on gains on property used in a trade or business, whether the tax-free rollover treatment on gains realized on the sale of a residence should be modified and finally whether any changes should be made in the capital gains treatment of patents.

For each of these subjects, the pamphlet describes present law and the major issues relevant to each. When the bill passed by the House (H.R. 10612) contained an amendment relating to one of these subjects, the House provisions also are described briefly. One or more subsequent pamphlets will discuss alternative proposals for dealing with these issues.

1. Holding Period

Present law

Capital gains on property held for less than six months are defined as short-term capital gains. Capital gains on property held for longer periods of time are treated as long-term capital gains. Short-term capital gains of individuals are taxed as ordinary income, but one-half of long-term capital gains in excess of short-term capital losses (net long-term capital gains) is generally excluded from adjusted gross income. Individuals also have the option of having the initial \$50,000 of net long-term capital gains taxed at a 25-percent alternative rate.

Individuals may deduct their capital losses to the extent of their capital gains and, if losses exceed gains, up to \$1,000 of these losses may be offset against ordinary income. If the net capital losses are short-term, they may be deducted against ordinary income on a dollar-for-dollar basis (up to the \$1,000 limitation), but only 50 percent of net long-term capital losses realized may be deducted against ordinary income. (Thus, \$2,000 of long-term capital losses is required to offset \$1,000 of ordinary income.) Individuals' losses in excess of the \$1,000 limitation may not be carried back to prior years, but there is an unlimited carryover to future years.

Issues

For the bulk of property, the capital gain in fact is usually spread over the holding period, but the realization of the gain which results in tax occurs only when the property is sold. When the asset has been held for a period of years, it is generally believed to be unfair to tax several years of accrual under the progressive rate structure as though it had been earned at one time.

The provision in present law providing a minimum holding period which distinguishes between short-term and long-term capital gains is intended to establish a fair procedure for taxing the realization of a capital gain that accrued throughout the holding period. Another basis for giving separate treatment to longer term capital gains is that since they can be realized or not, largely based on the taxpayer's decision, the regular tax rate might discourage realization. Others believe longer term capital gains either are not income or are not the same as other income.

Some critics of the present six-month holding period believe that it is too short. They suggest that capital gains realized within a 12-month period should be treated as ordinary income. They point out that the unfairness associated with the bunching in one year for tax purposes of a capital gain that accrued over several years is not present in this case. They note that other forms of income earned or realized within a 12-month period are treated as ordinary income. Proponents of maintaining the minimum holding period as it is in present law suggest that

property on which the capital gains accrue is a capital item and that the capital gain is a change in the value of the property, rather than income. If some gains are to be taxed as ordinary income, they believe the holding period for this treatment should be as short as possible.

Many items of property treated as capital assets for purposes of the tax are traded on organized stock exchanges. If the minimum holding period were to be increased from six months to one year, it is contended that the normal activity of the exchanges would be disrupted since trades that normally occur after the six-month holding period would then be deferred for a further six months. If stocks were held off the market until the longer holding period was met, stock prices might be bid up temporarily because buyers (as contrasted to sellers) would have no reason to defer their purchases merely because of a change in the holding period. Also, there would be a substantial loss in business for brokerage houses in the first six months after a change in holding period to one year.

There is little statistical evidence as to how long investors have held stock. A study by the Internal Revenue Service of stock transactions in 1962 indicates that of the total gain realized on stock transactions in that year, 6.0 percent was realized on stock held between 6 and 12 months and 5.4 percent on stock held less than six months. These statistics suggest that stock sales occurring in the second six months of holding do not account for a significant portion of market activity. About a quarter of those sales occurred during the seventh month of the holding period which suggests a short-term speculative (or income) rather than investment objective.

Preliminary statistical data from a new study by the Internal Revenue Service is being processed now and will be presented to the committee when it considers this subject. The behavior described in the 1962 study is consistent with the findings of earlier studies of capital gains and the related holding periods that were based on income tax data submitted to the Internal Revenue Service.

House bill

The House-passed bill increases the holding period defining long-term capital gains from six months to eight months in 1976, to ten months in 1977 and to one year in 1978 and future years. There is a transitional rule for installment sales, whereby if a gain would have been long-term in the year of the sale, it is considered long-term even if it is included in income on the installment basis in a year in which it would have been considered short-term. Gains on agricultural commodity futures contracts are exempted from the increase in the holding period.

2. Sliding Scale of Tax Rates for Long-Term Capital Gains

Present law

Capital gains from the sale of property held longer than six months are classified as long-term capital gains. Fifty percent of net long-term gains (after offsets for short- and long-term losses) are included in taxable income and generally are taxed according to the regular progressive tax rate schedule. The effect is to tax net long-term capital gains at half the rates that apply to other income. Net long-term capital gains up to \$50,000, however, are eligible for a 25-percent alternative tax rate. If property is held by a taxpayer until his death, the capital gain is not taxed at any time although his heirs take as their basis for the property its value at the time of death or six months thereafter.

Issues

Many believe that it is inappropriate to treat all long-term capital gains the same for tax purposes whether the asset has been held for just slightly over 6 months (or 12 months if the holding period should be changed) all the way up to perhaps 30 or 40 years or more. They contend that much of the gain in the case of these assets held for a long period of time represents increases in value due to inflation rather than real value. Therefore, it is suggested that some adjustment is appropriate so that the tax on capital gains will only apply to increases in real value.

There are two principal proposals which have been advanced to deal with the various types of problems referred to above. One of these is referred to as a sliding scale of tax rates. Under this proposal, the inclusion factor for capital gains would be reduced below 50 percent for capital gains held for longer periods of time with the exclusion factor being largest for those properties held for the longest period of time. A second type of proposal often advanced is called a basis adjustment under which the initial cost of the asset is increased by a percentage (either a constant annual percentage or a percentage varying with the annual change in the cost of living) for each year the property is held.

Those who believe that the issue is primarily that of adjusting for inflationary increases in value favor dealing with the problem by adjusting the cost basis of the asset upward rather than providing a sliding scale of capital gains excluded from tax. The benefit of an exclusion of a part of the gain under a sliding scale goes largely to the property which has greatly appreciated in value. On the other hand, even where there is only a small gain, it may be that all of this gain represents an inflationary increase and, as a result, no part of it should be subject to tax.

Others, however, favor an exclusion of part of the gain under a sliding scale which varies with the holding period. They believe that to tax capital gains held a long time similarly to those held for a short period of time discourages realization of the gains and contributes to the holding of assets (lock-in effect) longer than would be the economically desirable in the absence of tax considerations.

The payment of a large tax on a potential capital gain discourages realization because the taxpayer knows that if he does not dispose of the asset he can continue to benefit from the income attributable to the portion which would otherwise be paid in tax. As a result, the taxpayer may decide to hold the property until it will be included in his estate. In that event, neither he nor his heirs will be taxed on the gain since there is no tax imposed at the time of his death and the heirs receive a step-up-in-basis, or current value, for the property. In this way, the taxpayer avoids any taxation on the accrued gain, but any economic benefit from the exchange of assets to reflect changing circumstances and differing valuations has been lost because of the lock-in effect.

Others argue that a sliding scale exclusion in capital gains rates is needed to offset the fact that a property which has been held for many years may result in having the gain taxed at highly progressive rates without consideration for bunching of income that occurs on realization of the gain. To some extent, the averaging provision in present law under which capital gains may be included deals with this bunching problem. However, the present provision provides 5-year averaging and, therefore, does not adjust for bunching which occurs over a longer period of time.

3. Alternative Tax on Long-Term Capital Gains

Present law

Generally an individual taxpayer includes in income 50 percent of long-term capital gains in excess of capital losses. However, with respect to the first \$50,000 (\$25,000 for married individuals who file separate returns), he can elect to be taxed instead at a rate of 25 percent on the entire net long-term capital gain.

Issue

The alternative tax benefits only those taxpayers with marginal tax rates before their capital gains of 50 percent or more. This includes married couples with taxable income before taking into account their capital gains of over \$52,000 and single persons with incomes of over \$38,000. (For others, the application of the regular rates but with the exclusion of half the gain is more beneficial than the alternative rate.) At the same time, this alternative rate applies only to the first \$50,000 of capital gains. As a result, the area of its application is relatively limited. In 1972, for example, only 5 percent of capital gains were taxed at the alternative rate. (This contrasts with 33 percent prior to the Tax Reform Act of 1969.)

Proponents of the alternative tax contend that this provision is desirable because, for up to \$50,000 of capital gain, it limits the extent of the progressivity in the tax. They suggest that this may benefit those with incomes of \$52,000 or more (\$38,000 or more for single persons), who also have made a once-in-a-lifetime sale of an income-producing asset.

Before the 1969 Act, the alternative tax was available without the \$50,000 limitation. It was objected to at that time on the grounds that it limited the progressivity of the rate structure for those in the upper income tax brackets, much of whose income was received in the form of capital gains. The retention of the alternative rate, but with the \$50,000 limitation, represented a compromise of those with opposing positions in this area. The opponents of the present provision suggest that the existing provision is of limited application in any event and, therefore, primarily represents an added complexity in the law rather than any substantive relief. They also point out that there is no reason to believe that the provision has its primary application in the case of those having large, one-time, capital gains.

4. Deduction of Capital Losses Against Ordinary Income

Present law

Capital losses of individuals are deductible in full against capital gains, but the excess of capital losses over capital gains can be deducted against ordinary income only up to \$1,000 each year (\$500 for a married person who files a separate return). Only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income (since only 50 percent of a long-term capital gain would be included in income). Thus, \$2,000 of net long-term capital losses is required to offset \$1,000 of ordinary income. Capital losses in excess of the \$1,000 limitation may be carried over to future years indefinitely.

Issues

It is contended that a taxpayer should be allowed to deduct all his capital losses against ordinary income, after adjustment for the 50-percent exclusion rule. Such an approach is symmetrical with the inclusion in full of 50 percent of capital gains in taxable income.

Others disagree and point out that taxpayers have discretion over the timing of realization of capital gains and losses. As a result, unlimited deductibility of net capital losses against ordinary income would encourage investors to realize their capital losses immediately to gain the benefit of the deduction against ordinary income while they are deferring realization of their capital gains.

Some observers believe that although there should be limits on offsets of capital losses against ordinary income, the present \$1,000 limit should be increased, since prices have risen significantly since this deduction was originally enacted in 1942.

House bill

The House-passed bill increases the amount of ordinary income against which capital losses may be deducted from \$1,000 to \$2,000 in 1976, to \$3,000 in 1977, and to \$4,000 in 1978 and future years. These amounts are halved for married persons who file separate returns. As under present law, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income.

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5. Capital Loss Carryback

Present law

Under present law individuals can deduct capital losses to the extent of their capital gains. In addition, if an individual's capital losses exceed his capital gains, he can deduct capital losses against up to \$1,000 of ordinary income each year (\$500 for married individuals who file separate returns). Individuals' capital losses in excess of the \$1,000 limitation may not be carried back to prior years, but there is an unlimited carryover to future years.

Issues

It has been suggested that individuals, like corporations, should be able to deduct capital losses against prior years' capital gains. Under existing law, if an individual sustains capital losses in one year and capital gains in the next year, he can carry over the capital losses and deduct them against the subsequent capital gains. If his capital gains precede his capital losses, however, he cannot carry the capital losses back and deduct them against prior capital gains. It is believed that this result is inequitable and serves no useful purpose. Furthermore, it is pointed out that the failure to provide a capital loss carryback leads to tax-motivated selling at the end of each year. Investors who have realized capital gains in a year and who have unrealized capital losses cannot be sure that they will have capital gains in the future against which to deduct the capital losses, and as a result, in some cases, they realize their capital losses at the end of the year solely for tax purposes.

It is contended, on the other hand, that since the timing of the realization of capital gains and losses is largely in the control of the property owner, this does not usually represent an important problem for him.

Some have suggested that a capital loss carryback should be available primarily as a relief measure where it is unlikely that the carry-forward in perhaps the next 5 years will be adequate to offset the capital loss. Under present law, up to \$10,000 of capital loss could be offset against ordinary income in a carryforward over 5 years (under the provision included in the House-passed bill described in the preceding section, this is increased to \$4,000). It has been suggested that a carryback of capital losses is required on the grounds of equity for those who have had very large capital losses and have the prospect of receiving inadequate capital gains or ordinary income in the future to offset such a loss.

Others argue that a carryback of large losses would be beneficial primarily to the wealthy individual and of no benefit to new businesses which may not have capital gains in past periods against which the capital loss may be offset.

6. Capital Gains Treatment for Property Used in a Trade or Business

Present law

Under present law, depreciable property used in a trade or business is treated like a capital asset if the taxpayer realizes a net capital gain.¹ This means that in such a case, if the taxpayer is an individual he will receive the benefit of the 50 percent exclusion (and alternative rate limitation). If the taxpayer is a corporation, it will have the gain taxed at a maximum rate of 30 percent. On the other hand, when a taxpayer realizes a net capital loss on the sale of depreciable assets used in a trade or business, the net loss is treated as an ordinary loss and, therefore, may be deducted in full against ordinary income.

Current law also provides that in the case of depreciable personal property and in the case of certain other tangible property, not including buildings, the gain on the sale of the property is treated as ordinary income to the extent that depreciation deductions have been taken with respect to the property. In the case of real property, generally, depreciation taken to the extent it exceeds the amount that will be allowed under straight-line depreciation is treated as ordinary income up to the amount of any gain on the sale of the property.

Issues

In the case of personal property, it is understood that the recapture rules referred to above have the effect of treating most of the gain on the sale of property used in a trade or business as ordinary income despite the fact that the so-called general rule would treat this as capital gain. In view of this, questions have been raised whether, in the interest of simplification, it is more appropriate to apply ordinary income (as well as ordinary loss) treatment in the case of personal property used in a trade or business.

While there is general agreement that *tangible* personal property used in a trade or business generally is subject to ordinary loss treatment because of the recapture rules, it has been suggested that this was not true in the case of *intangible* personal property such as player contracts of sports teams. It is argued, in addition, that to treat such gains as ordinary income would present economic hardships for the sports teams involved.

¹This treatment applies only if the property is held for more than 6 months. This treatment is not available in the case of property properly includable in the taxpayer's inventory or in the case of property held for sale to customers or to a copyright literary, musical or artistic composition or letter or memorandum held by the person whose personal efforts created the property. The term "property" used in a trade or business also includes timber, coal and iron ore with a retained economic interest.

7. Tax Treatment of Capital Gains on Residences

Present law

Under present law, two special tax provisions are available for capital gains arising from the sale of an individual's principal residence. These are provided in addition to the general capital gains exclusion provision. First, when the proceeds of the sale of a taxpayer's principal residence are invested in a new principal residence, the taxpayer may defer realization of the gain on the sale of the old residence until he sells the new residence. Second, there also is an exclusion for the gain in the case of the sale of a principal residence for \$20,000 or less by a person age 65 or over who has used the house as a principal residence for 5 out of 8 years prior to sale. When the sales price exceeds \$20,000, the exclusion is a fraction equal to \$20,000 divided by the sales price. The provision of the exclusion for the elderly is, however, available only once.

Issues

There are several issues in current law as it relates to the tax treatment of capital gains on residences. With respect to the provisions for the elderly, it has been suggested that the \$20,000 base sales price is too low. In this view, the recent inflation, especially in the value of single family dwellings, has materially reduced the equity in the exclusion which was first provided in the Revenue Act of 1964. Since 1964, the general price level has risen 74 percent, and the index of housing costs 78 percent. There is also a question about whether the exclusion should relate to the base sales price, or the capital gain realized from the sale of the home. On the other hand, increasing the base sales price or extending the exclusion might result in permanently exempting an individual from ever paying capital gains taxes on residential property.

There are several issues related to capital gains on residences which involve the definition of a principal residence. Many public officials, including Members of Congress and the President, maintain a residence in Washington, D.C. and one elsewhere in the Nation. There are currently no special rules to determine which of these is the principal residence. For a Member of Congress who spends a considerable amount of time in his district, and who maintains a residence in Washington, the question is which is his principal residence. For the purpose of determining what are deductible travel expenses, a Member's residence is the residence in his district. However, it is also possible to treat a Washington residence as his principal residence for the purposes of nonrecognition of gain upon sale.



8. Gains on Sales of Patents

Present law

Under present law, gains on the sale or exchange of patents are treated as long-term capital gains if the sale or exchange is by the individual inventor whose efforts created the patent or by someone, other than the inventor's relatives or employees, who bought the patent from the inventor prior to the actual reduction of the invention to practice.

Issues

A reason often given for providing long-term capital gains treatment to inventors and certain purchasers of patents from inventors is to encourage this socially useful and risky activity. Under certain circumstances, however, long-term capital gains treatment for the sale of patents leads to a higher effective tax rate than would treatment as earned income. This occurs because of the combination of the regular income tax, the minimum tax, and the preference income offset to the maximum tax on earned income. An individual in the 70-percent bracket with a substantial amount of earned income in five consecutive years can have his capital gains taxed at an effective rate of 54.5 percent. (This is the sum of the 35-percent regular income tax rate, a 1.5-percent effective rate of minimum tax, a 10-percent increase in tax on earned income owing to the preference offset to the maximum tax in the year the gain is received, and 2 percent increases in tax on earned income in each of the next four years because of the five-year averaging provision in the preference offset.) Capital gains are also not eligible for such benefits as H.R. 10 plans or individual retirement accounts.

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